# SPROTT SMALL CAP EQUITY FUND

December 2016 Commentary

The Sprott Small Cap Fund had a relatively successful year in 2016 appreciating by 20%. This result was in excess of the upper end of our targeted annual performance band and compares to the average Canadian Small Cap Fund increasing by 17.8%. As a reminder while it is common to compare diversified Funds such as ours against benchmarks one must also then consider the risk inherent in the underlying index. Unlike in the United States where their economy (and thus their indices) are well diversified the Canadian small cap market tends to be very resource heavy. As a result given this concentration some indices can present too much risk or not fit with the performance objectives/desired level of volatility of a particular Fund Manager. In 2016 this aspect was very clearly exemplified when the materials sector (mainly gold) made up more than 30% of the S&P TSX Small Cap Total Return Index. To be "market weight" then a Fund Manager would have to have nearly 1/3 of his or her fund in junior mining stocks. This is not congruent with our style nor with the level of volatility that we target with the Sprott Small Cap Fund and is thus the reason for why we (and almost every single one of our competitors) underperformed the index last year as junior gold stocks performed exceptionally well.

Our approach is to manage the Sprott Small Cap Fund as two buckets. The first is to be invested in non-resource stocks which typically will make up 75% of the overall assets. In this bucket we primarily target stable, not terribly exciting dividend payers which due to the inefficiencies of the small cap market can pay dividend yields that are significantly higher than what many would think to be sustainable (average dividend yield of dividend names in the Fund = 6.1%). This underlying dividend yield offers the Fund a bedrock of annual performance and we also try to identify dividend payers which will have the ability over time to give us annual pay raises. Also within the non-resource bucket we will typically hold 2-3 "alpha" picks which will have the potential for meaningful capital appreciation but lacks the underlying dividend support. In the resource bucket which typically will make up the remaining 25% we seek to leverage our strong energy background (The Sprott Energy Fund is the #1 performing Energy Fund in Canada on a 1 and 3 year basis as at December 30, 2016)[2] to generate further returns.

In 2016, 2 of our top 10 performance contributors were in the non-resource, non-alpha bucket (Exchange Income Fund and Chorus Aviation). The remaining 8 were energy names as we took several meaningful positions in oil companies and service companies. Our best performers in the year were Baytex Energy, Trican Well Services, Canyon Services Group, and Cardinal Energy. Demonstrating what a challenging year it was for non-resource small caps nearly all of our performance detractors were non-resource stocks (NYX Gaming, Grenville Strategic Royalty, Air Canada, and Martinrea). NYX was particularly disappointing to us as it was by far the biggest weighting in the Fund (and remains so). We underappreciated that despite trading at an attractive P/E relative to its future earnings growth rate in an industry growing by 10% per year that the corporate shenanigans perpetrated by some of its public peers would taint the space and cause investors to flee all of the public online gambling stocks. We intend to stick to our guns on this position for another few quarters to see if improved execution can cause the stock to move closer to where we see a more proper valuation however this one position did cost the Fund over 5% of lost performance on the year.

Looking to 2017 the Fund has begun the year with a slight overweight (ie. higher than our typical 25%) towards energy as we are attracted to the material upside potential in oil stocks as the market begins to appreciate the degree of inventory drawdowns that will be occurring as a result of strong demand growth, falling non-OPEC supply, and the impact of the 6 month OPEC curtailment. We believe oil inventories could normalize by the end of 2017. Our dividend basket remains largely unchanged. For our alpha picks we as mentioned have retained NYX Gaming giving the position a few more quarters to start contributing positive performance. We have also reinitiated a position in Air Canada. We are compelled by the highly attractive valuation, much improved balance sheet, potential for actual free cash flow, and the fact that nearly every flight we have been on recently has been full/oversold.

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Thank you for your investment and confidence in us over the past year. We look forward to reporting on our continued success in the quarters ahead.

**Eric Nuttall**
*Portfolio Manager*
Sprott Small Cap Equity Fund

## *COMPOUNDED RETURNS (%) AS AT DECEMBER 30, 2016[1]

| | 1 MTH | YTD | 3 MTH | 6 MTH | 1 YR | 3 YR | 5 YR | ANNUALIZED INCEPTION (08/23/07) |
|---|---|---|---|---|---|---|---|---|
| SPROTT SMALL CAP EQUITY FUND, SERIES A | 6.6 | 20.0 | 7.7 | 9.0 | 20.1 | 4.6 | 2.4 | 2.8 |
| S&P/TSX SMALLCAP TRI | 3.9 | 38.5 | 3.1 | 8.2 | 38.5 | 5.4 | 4.3 | 2.2 |

SPROTT ASSET MANAGEMENT

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1 All returns and fund details are a) based on Series A units; b) net of fees; c) annualized if period is greater than one year; d) as at December 30, 2016; e) 2007 annual returns are from 08/23/07 to 12/31/07. The index is 100% S&P/TSX SmallCap TRI and is computed by Sprott Asset Management LP based on publicly available index information.

2 Sprott Asset Management LP internal estimate.



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